

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

No. 77-6034

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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In the Matter of
WEIS SECURITIES, INC., Debtor.
GEORGE ALDRICH, et al.,
vs.
EDWARD S. REDINGTON, Trustee, and
SECURITIES INVESTOR PROTECTION
CORPORATION,

P/S

Appellants,

Appeal from the United
States District Court
for the
Southern District
of New York

Appellees.

**REPLY BRIEF FOR APPELLANT,
EVA GROSSMANN**

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Oral Argument Requested

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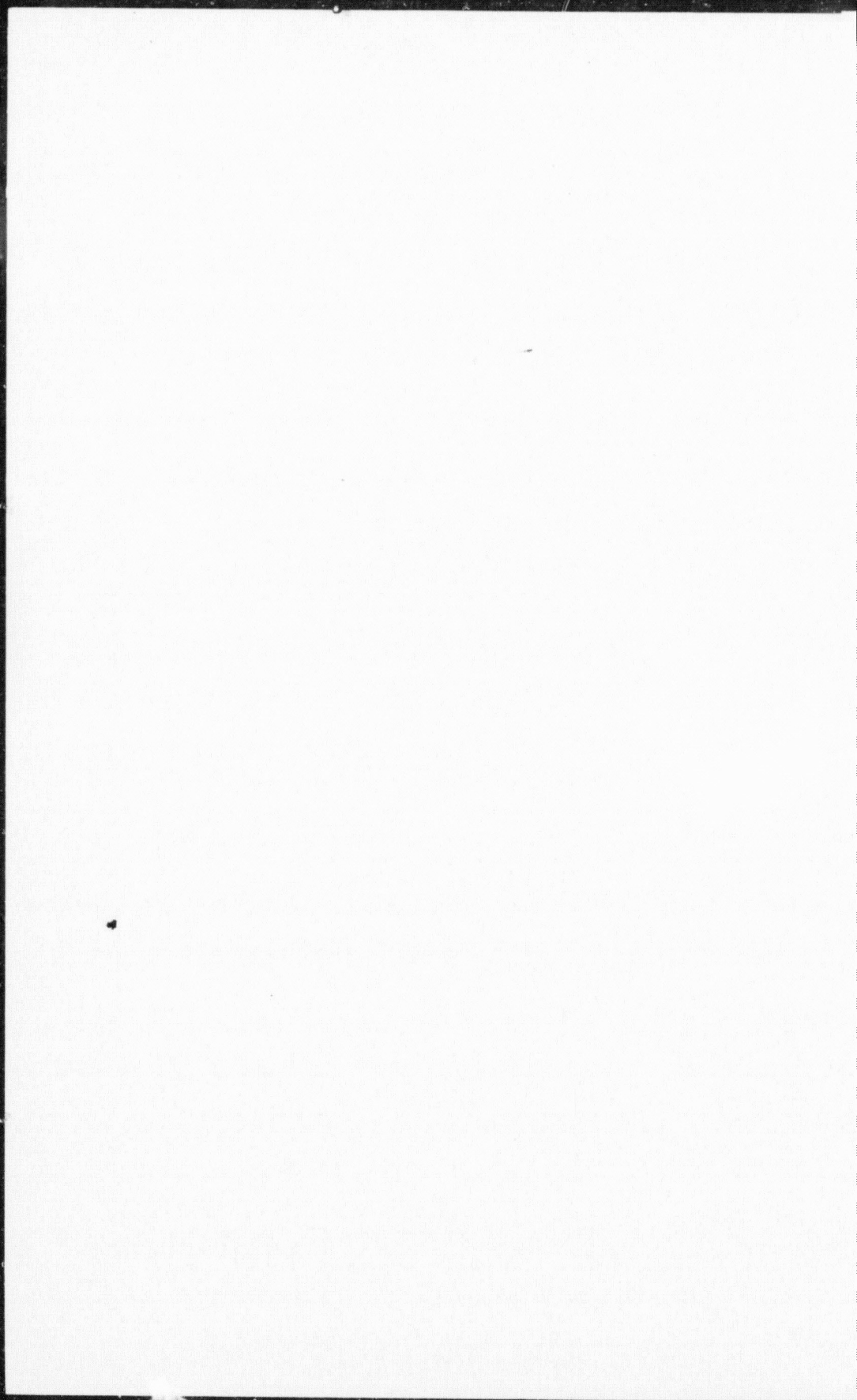
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**REPLY BRIEF FOR APPELLANT,
EVA GROSSMANN**

**APPELLEES' ARGUMENT IS BASED UPON
WRONG PREMISES.**

The Trustee's and SIPC's argument is premised upon the so-called lenders' conscious entering into subordinate debenture agreements and the New York Stock Exchange's innocence in participating in any of the debtor's misconduct. This premise is blatantly wrong as far as Mrs. Grossmann is concerned.

Appellees strenuously contend that Mrs. Grossmann should be treated as any other subordinate debenture holder; they refer to Mrs. Grossmann's statement that she thought at the time when she was first handing over \$15,000. to Weis, Voisin, Cannon's vice-president upon his inducement and prodding that she was buying stock in the company and that the vice-president had told her it "was like a loan to the company". How those statements can be seriously interpreted as indicating any knowledge on her part that she was buying or investing in *subordinate debentures* or that she understood the import or nature or the legal consequences of her investment is indeed incomprehensible and lacking in any rational basis, especially in the face of the undisputed facts in the record.

Whatever her thoughts were, the stark fact remains that she, lacking completely in any understanding of financial matters, relied solely and completely upon the advice and superior knowledge of the broker and, upon his inducement, invested all her life savings in securities which did not deserve that appellation and were completely unsuitable for a person of her status and means. The evil was compounded by the broker's deliberate failure to inform and enlighten her about the precarious nature of the investment and the risk involved therein, thus deceptively concealing material facts from her.

It is of course no answer, as attempted to be given by appellees, that Mrs. Grossmann received a high rate of return on her investment for six years and that no one could foresee at that time that the investment would later turn bad. Whether the investment yielded initially a high rate of return is completely irrelevant; relevant is that under the factual circumstances the investment was bad and improper *ab initio*, conceived and afflicted with the congenital deficiency of fraud and unsuitability. It is

always after a loss has materialized that the defrauded party becomes aware of the deceit practiced upon him. This is precisely the situation presented here.

**MRS. GROSSMANN WAS DEFRAUDED WHEN SHE
ORIGINALLY INVESTED HER FUNDS.**

A further non-sequitur can be found in appellees' contention that Mrs. Grossmann's investments in 1967 and 1969, respectively, occurred "long before the acts of fraud alleged by other Lenders took place", and that "her investment was relied on by regulatory authorities as part of the net capital of the Debtor for nearly six years". That assertion again ignores the paramount and salient fact that Mrs. Grossmann was defrauded by Weis, Voisin, Cannon *at the time when she was deceitfully induced* to hand over her life savings in exchange for an investment which she was led to believe was safe and sound. It was at that time that the fraud occurred and the constructive trust arose. Since she never occupied, in legal effect, the status of a subordinate debenture holder, she cannot be regarded as such in legal contemplation.

Appellees attempt to obviate the clear legal consequences resulting from the undisputed facts in the record by boldly claiming that Mrs. Grossmann cannot establish that anyone took money from her "deceitfully" or "under false pretenses". In making that assertion, appellees discreetly ignore the facts and legal argument stated in Mrs. Grossmann's brief (pp. 18-23), which demonstrate the broker's deceitful and fraudulent conduct in violation of pertinent federal and state statutes. Thus, not a word is mentioned by appellees of the brazen flouting of the "Know Your Customer Rule"—Rule 405 promulgated by the New York Stock Exchange—a violation committed by the broker and

countenanced by the New York Stock Exchange. Not a word is mentioned of the fraudulent withholding of material facts by the broker in gross contravention of the Illinois Securities Law and the Illinois Consumer Fraud Act, statutes equally applicable to the transaction under Section 18 of the Securities Act (15 U.S.C. § 77r). Yet, spreading the cloak of silence over these facts and occurrences does not make them disappear. They remain as a constant reminder and proof of the broker's unlawful conduct and refute any claim that Mrs. Grossmann knowingly and consciously ever occupied the status of a subordinate debenture holder.

Moreover, appellees, as well as the District Court, assumed that fraud was practiced upon the claimants; in doing so, they did not differentiate between types of fraud wrought upon the claimants and did not confine their assumption to the fraud emanating from the debtor's false financial statements. Hence, appellees acknowledged—at the very least for the purpose of the motion for summary judgment—that Mrs. Grossmann was defrauded by Weis, Voisin, Cannon when she was induced to invest her meager funds in the so-called securities sold to her by the broker. Thus, appellees cannot now be heard to deny the existence of such fraud and retract their previous acknowledgement of it.

Additionally, appellees may not, at this stage of the proceedings, deny the existence of a "constructive fraud" practiced by Weis, Voisin, Cannon, upon Mrs. Grossmann. In having acknowledged, as just mentioned, fraudulent conduct on the part of the broker—an acknowledgment accepted by the District Court—the appellees have also admitted the existence of the constructive fraud flowing from and implied in the brokerage firm's relationship to Mrs. Grossmann.

In equity—and the present liquidation proceedings are equity proceedings—any kind of wrongdoing leading to the imposition of a constructive trust as a “fraud-rectifying” device will be considered fraud and will “not [be] confined to an intentional false representation”. (Bogert (Hornbook): *Handbook of the Law of Trusts*, West Publishing Co., 5th ed., 1973, chap. 8, p. 287). Moreover, the existence of the confidential relationship between Mrs. Grossmann and Mr. Meiselman, the agent of Weis, Voisin, Cannon, appears clearly from the undisputed facts in the record which form the legal basis for the Court to impose a constructive trust. Such a trust is not created by the parties, but, as just indicated, is imposed and decreed by the Court to rectify the wrong suffered by the injured party. Hence, it is immaterial whether or not the appellees have admitted the existence of a “confidential” relationship between Mrs. Grossmann and the broker, since, as repeatedly mentioned, such a relationship is determined by the Court upon the basis of the facts in the record. It is respectfully submitted that the facts in the record unmistakably demonstrate the existence of such relationship, making it, therefore, completely irrelevant whether appellees have or have not conceded the relationship. Parenthetically, it should be mentioned that appellees’ statement in their brief (p. 42) that they have never conceded the confidential relationship between the broker and Mrs. Grossmann “(a factual matter not conceded by SIPC or the Trustee)”, demonstrates patently that the summary judgment was improperly entered, since disputed factual matters exist; obviously, Mrs. Grossmann cannot be deprived, by the entry of a summary judgment, of her right to prove the salient facts of her claim, if these facts are disputed.

Appellees also claim that there is nothing to which a constructive trust could attach since Mrs. Grossmann's money became part of the broker's working capital. Yet, this is the typical case where a person mingles funds wrongfully obtained with his own funds. In such an instance, the wronged person is entitled to either a portion of the commingled fund proportioned to his contribution thereto, or he may assert an equitable lien on the entire fund for the amount of his money. This principle has been repeatedly recognized by this Court (see, for example, *Marcus v. Otis*, 168 F.2d 649) as well as other courts (*Grodsky v. Sipe* (E.D. Ill. 1940), 30 F.Supp. 656) and the Restatement of the Law of Restitution (§ 209).

The cases cited by appellees do not touch that principle; they are inapposite. In *United States v. Randall*, 401 U.S. 513, the majority opinion merely held that the amount of taxes withheld by a debtor after he had been adjudicated a bankrupt, which taxes he had not deposited in a special account, despite a court order to that effect, should not receive priority over the costs and expenses of administration in the bankrupt's estate, particularly since such a preferential trust for taxes would eat up the estate "leaving little or nothing for creditors and court officers whose goods and services created the assets." (401 U.S. at 517). It needs not any elaboration that the factual and legal situation presented in the instant case is diametrically different from that encountered in *Randall*. In *Randall* the government set forth a statutory trust tax claim which, if granted, would have wiped out all the assets of the bankrupt's estate during the Chapter XI reorganization proceedings, thereby frustrating and defeating the basic statutory purpose of these proceedings, and, above all, reversing the distributive scheme of the Bankruptcy Act

by giving a claim for taxes priority over the estate's administrative expenses. In the present case there is no interference with the distributive scheme of the Bankruptcy Act, but merely the enforcement of a trust against the bankrupt's estate, thereby preventing the use of trust funds by the Trustee for the purpose of satisfying the bankrupt's liabilities with monies not belonging to the bankrupt's estate. It is too late in the day to argue that trust funds may be used in such a manner, particularly if the relatively small amount is considered which is involved in the present trust claim; surely that small sum of money would hardly cause even a dent in the assets available to the other claimants, and most certainly not upset or interfere with the distributive scheme of the Bankruptcy Act. As just indicated, it is elementary that a trustee in bankruptcy stands in the shoes of the bankrupt debtor and if the debtor has been in the possession of trust property, the bankruptcy or reorganization trustee holds the property covered by a trust subject to the outstanding interest of the beneficiary. (See *In Re Prudence Bonds Corporation* (2nd Cir. 1935), 79 F.2d 212, 215; Judge L. Hand in *In Re Commonwealth Bond Corp.* (2nd Cir. 1935), 77 F.2d 308, 309; and *Grodsky v. Sipe* (E.D. Ill. 1940), 30 F.Supp. 656).

Equally inapposite is *In Re Faber's Inc.*, 360 F.Supp. 946, cited by appellees. In that case, the petitioners sought to have a constructive trust impressed upon the bankrupt's assets in contravention of the controlling state law which did not recognize the imposition of a constructive trust in such instances as set forth by petitioners, contrary to the present case in which the recognition of the imposition of a constructive trust is established doctrine. It is also clear that the Court's dicta in the *Faber* case regarding a state law's

interference with the distributive scheme of the Bankruptcy Act find no application in the present situation because no novel trust theories are created here, as was attempted in the *Faber* case, and therefore, no disguised and new priorities in contravention of the Bankruptcy Act's distributive scheme are established.

MRS. GROSSMANN NEVER OCCUPIED THE STATUS OF A SUBORDINATE DEBENTURE HOLDER.

Appellees also ignore the uncontroverted fact that Mrs. Grossmann never received a debenture certificate for the \$5,000., which she had given to Weis, Voisin, Cannon in 1969, and was merely notified by that firm that the sum of \$5,000. was received for her "Debenture Account" (GA9; A. 149); no mention was made of a "subordinate debenture", nor was that fact ever made known to her at the time when she handed over the first \$15,000. to the broker. How she can be regarded a subordinate debenture holder under these undisputed circumstances is indeed incomprehensible. Of course, appellee's silence on that point is understandable because no sensible response can be given, controverting the fact that she never legally became a subordinate debenture holder.

Additionally, it must be kept in mind that Mrs. Grossmann never occupied a subordinate debenture relationship to Weis Securities of whose existence she learned only a few weeks before the commencement of the liquidation proceedings. She never gave any money to Weis Securities nor was any debenture certificate ever issued to her by Weis Securities. Thus, for that reason alone, she cannot be considered a subordinate debenture holder with respect to Weis Securities. Again, it is no answer to the statement of lack of a subordinate

debenture relationship between Grossmann and Weis Securities to assert, as appellees do (p. 43), that Weis, Voisin, Cannon's name was simply changed to Weis Securities on April 9, 1973, a few weeks before the initiating of the liquidation proceedings. The paramount fact remains that for all outer appearances Weis Securities was not the same legal entity as Weis, Voisin, Cannon with which alone Mrs. Grossmann had her business relationship. The very least which appears to be present in the instant case is the lack of important facts in the record, withdrawing thereby any legal basis for summary judgment.

Appellees state on page 43 of their brief that every party, save Mrs. Grossmann, acknowledges that Weis, Voisin, Cannon and Weis Securities are the same. However, there is no evidence in the record of the nature of the transaction between Weis, Voisin, Cannon and Weis Securities, and other claimants have certainly not indicated in their pleadings that the creation of Weis Securities was merely the result of a name change. Indeed, Mrs. Grossmann was given no notice of any corporate transfer or reorganization. This is precisely the reason why claims for rescission based on the fraudulent activities of the debtor cannot be summarily disposed of by the estoppel theory proposed by the Trustee and adopted by the District Court; nor can the facts which must be elicited to prove a violation of the Bulk Sales Acts be conveniently avoided by the granting of the Trustee's motion for summary judgment.

Legitimate legal and factual issues are raised by Mrs. Grossmann's claim that the transfer of Weis, Voisin, Cannon to Weis Securities was in violation of the Illinois and New York Bulk Sales Acts, Ill. Rev. Stat., ch. 26, secs. 6-101 *et seq.*; N.Y. Laws, ch. 62½, secs. 6-101 *et seq.*, and a fraud upon the creditors of Weis, Voisin, Cannon.

In *Sapphire Corp. v. American Mercury Magazine*, 138 N.Y.S. 2d 286 (1955), the court recognized that the transfer of all assets of a business, "lock, stock and barrel," and the maintenance by the vendee of that same business as a going concern was within the purview of the Bulk Sales Acts. Citing *Ben Bimberg & Co., Inc. v. Unity Coat & Apron Co., Inc.*, 270 N.Y.S. 580, 582, *aff'd* 280 N.Y.S. 220 (1934), the court acknowledged that "[i]t is the character and effect of the sale, rather than the nature of the business, that supplies the chief test." The "lock, stock and barrel" theory was expressly distinguished from the mere sale of one or more intangible assets of a business in *Standard Milling Co., Inc. v. Yoss*, 16 UCC Reporting Service 815, 817 (1975), a case relied upon by the appellees. Hence appellees' contentions as to the inapplicability of the Bulk Sales Acts are incorrect.

Even the appellees, on page 44 of their brief, concede that the rights of Mrs. Grossmann under the Bulk Sales Acts give rise to questions of fact whether the transfer of Weis, Voisin, Cannon to Weis Securities was fraudulent or unfair. Therefore, if there is the slightest doubt as to the legality of that transfer vis-a-vis Mrs. Grossmann as a creditor, a charge that the transfer of Weis, Voisin, Cannon to Weis Securities was in violation of the applicable Bulk Sales Acts raises questions of fact which Mrs. Grossmann is entitled to litigate and which may not be foreclosed by summary judgment.

Recognizing that Mrs. Grossmann never consciously occupied the status of a subordinate debenture holder, it becomes apparent, as stated in her brief (pp. 26-34), that she, if not a beneficiary under a constructive trust, must be classified as a customer under the intent and the pertinent provisions of the SIPA. She must be considered in legal contemplation as a "person who has

deposited cash with the debtor for the purpose of purchasing securities" or a person having "claims against the debtor arising out of . . . conversion of . . . securities." (15 U.S.C. 78 fff(c)(2)(A)(ii)).

Reference to and comparison with other claimants as made by appellees is completely inappropriate, not only because the factual situation pertaining to Mrs. Grossmann and the legal consequences flowing therefrom are completely different but also, and above all, because Mrs. Grossmann, as repeatedly emphasized, did not knowingly enter into any subordinate debenture agreement, despite all the contrary contentions of appellees.

S.E.C. v. Baroff Company, Inc. (2nd Cir. 1974), 497 F. 2d 280, cited by appellees, does not disapprove but, on the contrary, strongly confirms Mrs. Grossmann's claim that she must be treated as a "customer" under the SIPA in the instant case. In *Baroff*, the claimant deliberately loaned securities to a brokerage firm in order to help the firm overcome its financial difficulties. Although a literal reading of the Act would have categorized him as a "customer," this Court did not accord him that status. In doing so this Court referred to Judge Learned Hand's admonishment "not to be caught in the trap of language which seems, literally, too broad or too narrow to accommodate the patent legislative purposes." (497 F. 2d 280 at 282). Proceeding from that principle this Court pointed to the clear legislative intent to protect the "investor" and declared that "[t]he emphasis throughout was on the customer as investor and trader, not on others who might become creditors of the broker-dealer for independent reasons." (497 F. 2d 280 at 283).

The uncontroverted facts in the present case demonstrate clearly that Mrs. Grossmann came to Weis, Voisin, Cannon as an investor; she wanted to securely invest her life savings. That was the reason and the only reason she approached the broker, implicitly relying upon his expertise and superior knowledge. To deny her relief would make a mockery of the Securities Investor Protection Act.

CONCLUSION

It is respectfully reiterated that the District Court's summary judgment be reversed and appropriate relief be granted to claimant, Eva Grossmann.

Respectfully submitted,

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JULY 1, 1977

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GEORGE ALDRICH, et al.,
vs Appellants,

EDWARD S. REDINGTON, Trustee, and
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Appellees.

No. 77-6034

The undersigned being first duly sworn, deposes and says that he served 2 copies of the REPLY BRIEF FOR APPELLANT, EVA GROSSMANN in the above entitled cause by depositing the same in the United States Mail at Chicago, on the 1st day of July, 1977 properly stamped and addressed to

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Subscribed and sworn to before me
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My Commission expires 11-27-77.

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